IN THE

Supreme Court of the United States

OCTOBER TERM, 1952

PARK & TILFORD DISTILLERS CORPORATION,
Petitioner,

—against—

THE UNITED STATES OF AMERICA,
Respondent.

No. 544

PETITIONER'S REPLY BRIEF

Respondent's brief lends added force to the arguments made by petitioner in support of its petition for certiorari.

1. Although the government has successfully contended in the courts that the obligation imposed upon the insider by Section 16(b) is in the nature of a penalty and that the insider's payment of 16(b) "profits" to the corporation is, therefore, not deductible from his gross income (*William F. Davis, Jr.*, 17 T. C. 549; *William F. Dempsey*, 10 T. C. M. 936), the government has taken a contrary position in the present litigation. In the lower court the government argued that a 16(b) payment is not a penalty, and in this Court it argues that the question whether a 16(b) payment is a penalty is not even raised (Br., pp. 7-8, f. n. 1.).

The government's advocacy of these conflicting positions is doubtless the result, not of a desire to be unfair to the taxpayer, but of its own uncertainty as to the law. Whether a 16(b) payment is or is not a penalty is an important question

of Federal law which has not been decided by this Court. If the Court should ultimately hold that a 16(b) payment is a penalty, then petitioner's receipt of the moneys in question would not be taxable because of the "rule of long standing" which has "never been questioned in any court" that the receipt of punitive damages does not constitute taxable income.* *Glenshaw Glass Co.*, 18 T. C. No. 108. That rule is so firmly established that in *William Goldman Theaters*, 19 T. C. No. 79 (1/9/53), the Tax Court said it would adhere to the rule until the cases on which it is based are "overruled or until Congress by legislation requires that punitive damages be taxable as income."

2. Respondent's brief underscores petitioner's contention that the decision below is in conflict with the *Central Railroad* and *Cuba Railroad* cases, 79 F. 2d 697 and 268 U. S. 628.

Respondent summarizes the *Central Railroad* case as holding "that the payments to the railroad corporation were in the nature of a windfall and were therefore not taxable" (p. 10), and cites the *Cuba Railroad* case for the proposition that "a subsidy paid to the railroad did not constitute

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*According to respondent (Br., p. 9), this result would not obtain because:

> ". . . whether or not the payment in question is characterized as penal, the language of Section 22(a) of the Internal Revenue Code, imposing a tax upon 'income derived from any source whatever,' is clearly broad enough to include it within its purview, and no provision of the statute excludes such payments from gross income."

However, it only begs the question to argue that receipt of 16(b) "profits" constitutes "income" because 22(a) imposes a tax on "income". The very question involved herein is whether the receipt of 16(b) "profits" does constitute "income". Moreover, it is not the law that every increase in net worth results in "income" unless it is excluded by express statutory provision.

income, but was a windfall not subject to tax." (Br., p. 11). The court in the instant case also held the payment to the corporation to be a windfall, but then went on to hold that a windfall *is* taxable, even to a greater extent than wages, salaries and profits (R. 19). In view of these diametrically opposite conclusions on the taxability of "windfalls", it would be laboring the obvious for petitioner again to contend that there is a conflict in decisions which only this Court can resolve.

Respondent in effect concedes (Br., pp. 9-11) the existence of a conflict between the decision below and the *Central Railroad* case, but argues that the conflict "does not require resolution by this Court" because respondent believes the *Central Railroad* case was "incorrectly decided." The fact remains, however, that the *Central Railroad* case has not been reversed and that the holding in that case, *viz.*, that recovery of a "penalty imposed by the law on a faithless fiduciary" does not constitute taxable income to the recipient, is in direct conflict with the lower court's decision in the instant case.

Respondent attempts to distinguish the *Cuba Railroad* case by urging that it "merely involved the question of whether a donation or a voluntary contribution was taxable income" (Br., p. 11), but it is difficult to understand that characterization in view of Mr. Justice Butler's statements that the Cuban Congress authorized the granting of a subsidy up to $6,000 per kilometer to the companies with whom the President of Cuba had contracted for the construction and operation of railroad lines on designated routes and that the "subsidy payments were proportionate to mileage completed; . . ." (268 U. S. at p. 632). If the subsidy payments in the *Cuba Railroad* case were "not made

for services rendered or to be rendered" and were not "profits or gains from the use or operation of the railroad" and therefore not "income within the meaning of the Sixteenth Amendment" (268 U. S. at p. 633), then, *a fortiori,* the 16(b) payments in the instant case were not made to petitioner for services rendered or to be rendered; they are not profits or gains from the use or operation of petitioner's business; and they do not constitute income within the meaning of the Sixteenth Amendment.

3. Respondent cites *Robertson* v. *United States,* 343 U. S. 711, for the proposition that the payment involved herein constitutes income to the recipient because made in discharge of a legal obligation created by statute (Br., p. 7). The *Robertson* case, it is submitted, is no authority for that proposition.

The *Robertson* case holds that "acceptance by the contestants of the offer tendered by the sponsor of the contest creates an enforceable contract", that "payment of a prize to a winner of a contest is the discharge of a contractual obligation", and that the "discharge of legal obligations — the payment for services rendered or consideration paid pursuant to a contract — is in no sense a gift" (p. 713). The holding in the *Robertson* case is carefully limited to situations where the obligor has received some consideration from the obligee, *e. g.,* services rendered or a contractual right. It is the obligor's receipt of that consideration which creates the legal obligation in the obligor to pay for the services rendered or the contractual right.

Unlike the *Robertson* case, Mr. Schulte's payment of 16(b) "profits" to petitioner is not "the discharge of a contractual obligation", nor is it "consideration paid pursuant to a contract". Unlike the *Robertson* case, there was in the

instant case no offer and acceptance and no enforceable contract between the recipient of the payment and the payor. Mr. Schulte's obligation to petitioner was created not by any consensual relationship between them but by express statutory provision. The discharge of that kind of legal obligation is, it is submitted, outside the *Robertson* case. Indeed, if the discharge of an obligation created not by the obligor's receipt of consideration flowing from the obligee, but by express statutory provision, were held to result in income, then the payment of punitive damages, because in discharge of a legal obligation, would also constitute income to the recipient. That result, however, would fly in the face of the settled rule that receipt of punitive damages does not constitute income. *Glenshaw Glass Co.*, 18 T. C. No. 108, *supra; William Goldman Theatres,* 19 T. C. No. 79, *supra,* and cases cited therein.

4. Although two very recent Tax Court decisions* (*General American Investors Company, Inc.,* 19 T. C. No. 73 (12/30/52), and *Noma Electric Corporation,* par. 53007 P-H Memo T. C. (1/8/53)) arrive at the same end results as in the decision below, *viz.,* that insiders' profits are taxable to the corporation under 22(a), a third very recent Tax Court case (*William Goldman Theaters, Inc.,* 19 T. C. No. 79 (1/9/53)) evinces a deep-rooted conflict

*These decisions came to petitioner's attention after the petition herein was filed and, in order to bring them promptly to the attention of this Court, a supplemental brief was prepared by petitioner and tendered to the Clerk of this Court for filing on January 21, 1953. The Clerk indicated he could not accept such supplemental brief for filing, and suggested that a typewritten copy be handed to counsel for the respondent with the statement that the substance of such brief would be incorporated in petitioner's reply brief. A typewritten copy of such supplemental brief was handed to counsel for the respondent on January 22, 1953.

between the Tax Court and the Court of Claims on fundamental principles of federal tax law, relevant to the decision herein.

The conflict is quickly apparent upon a comparison of the decision below with the *William Goldman* case, which held that only one third of a treble damage judgment in an antitrust suit represents compensatory damages for loss of profits and is taxable as income to the recipient and that two thirds of such judgment represents punitive damages, which are not taxable. Thus, although the Court of Claims declined to follow the definition of income set forth by this Court in *Eisner* v. *Macomber*, 252 U. S. 189, the Tax Court reaffirmed that definition in the *William Goldman* case by quoting from its decision in *Highland Farms Corporation*, 42 B. T. A. 1314, 1322, as follows:

> "A penalty imposed by law does not meet the test of taxable income set forth in *Eisner* v. *Macomber*, 252 U. S. 189, as 'the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. See also, *Central R. Co. of New Jersey* v. *Commissioner*, 79 Fed. (2d) 697, where it was held that a penalty imposed by law upon a faithless fiduciary was not taxable income."

Again, although the Court of Claims declined to follow the decisions in the *Central Railroad* and *Highland Farms* cases because they "seem to rest only upon the definition of income given by the Supreme Court in *Eisner* v. *Macomber*" and therefore "do not seem to us persuasive", the Tax Court in the *William Goldman* case held that it "must follow" both those cases, as well as the *Glenshaw Glass* case (18 T. C. No. 108, cited in petitioner's main brief at pp. 12-13), until

such time as those cases are "overruled or until Congress by legislation requires that punitive damages be taxable as income."

If the Tax Court in the *William Goldman* case is correct in following the "established decisions" resting on *Eisner* v. *Macomber* and in reaffirming the income definition contained therein, then the Court of Claims is clearly wrong in declining to follow those cases and in holding that the definition of income contained in the *Macomber* case is no longer regarded as authoritative. Only this Court can resolve that basic conflict.

Conclusion

This Court, it is respectfully submitted, should grant certiorari in order:

(1) to settle an important question of Federal law, *viz.*, whether a 16(b) payment is a penalty;

(2) to settle an important question of Federal tax law which has been incorrectly decided by the lower court, *viz.*, whether the receipt of a 16(b) payment constitutes taxable income;

(3) to resolve the conflict between the decision below and, among others, the decision in the *Central Railroad* case and this Court's decision in the *Cuba Railroad* case;

(4) to review and reverse the extraordinary and erroneous principle of law enunciated by the lower court, *viz.*, that every increase in net worth constitutes taxable income to the recipient unless excluded by express statutory provision; and

(5) to resolve the question whether the government is permitted to tax the same moneys two, or even three, times (a) by collecting an income tax from the "insider" upon his realization of gains in the very stock transactions which give rise to a 16(b) liability, (b) by denying the "insider" an income tax deduction, either as an ordinary loss or in reduction of his capital gains, on his payment to the corporation of the 16(b) "profits" previously taxed, and (c) by collecting an additional income tax and, as in the instant case, a personal holding company tax from the corporation upon its receipt of 16(b) "profits".

Respectfully submitted,

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